Proposed Respondent
JPK Kelly
First
JPKK1
8 May 2015

Waterfall II Application

No. 7942 of 2008

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
COMPANIES COURT

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N :

(1) ANTHONY VICTOR LOMAS
(2) STEVEN ANTHONY PEARSON
(3) PAUL DAVID COPLEY
(4) RUSSELL DOWNS
(5) JULIAN GUY PARR

(THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION))

Applicants

- and -

(1) BURLINGTON LOAN MANAGEMENT LIMITED
(2) CVI GVF (LUX) MASTER S.A.R.L
(3) HUTCHINSON INVESTORS, LLC
(4) WENTWORTH SONS SUB-DEBT S.A.R.L
(5) YORK GLOBAL FINANCE BDH, LLC

Respondents

- and -

GOLDMAN SACHS INTERNATIONAL

Proposed Respondent

FIRST WITNESS STATEMENT OF JONATHAN PATRICK KNOX KELLY

I, **Jonathan Patrick Knox Kelly**, a partner in the firm of Cleary Gottlieb Steen & Hamilton LLP, 55 Basinghall Street, London, EC2V 5EH **say as follows:**

INTRODUCTION

1. I am a solicitor of the Senior Courts of England and Wales and a Partner in the firm of Cleary Gottlieb Steen & Hamilton LLP, solicitors for Goldman Sachs International ("**Goldman Sachs**") as holder of a claim against Lehman Brothers International Europe (In Administration) ("**LBIE**"). I have conduct of this matter and I am duly authorised to make this witness statement on behalf of Goldman Sachs.

2. The facts and matters set out in this witness statement are within my knowledge from my handling of this matter or are based on information and documents provided to me by Goldman Sachs, and I believe them to be true.

3. There is now produced and shown to me a paginated bundle of documents marked "**JPKK1**" to which I refer in this statement. References to page numbers below are references to this bundle.

4. For the avoidance of doubt, nothing I say in this witness statement is intended to be, nor should be taken to be, a waiver of any legal professional privilege vesting in Goldman Sachs, save only and strictly limited to the extent of the text expressly referred to in this statement.

5. I make this witness statement in support of Goldman Sachs' application for an order, pursuant to CPR 19.2(2), that Goldman Sachs be added as an additional Respondent to the application for directions issued by the Joint Administrators of LBIE (the "**Joint Administrators**") on 12 June 2014 (the "**Application**").

6. For ease of reference, I adopt the following headings in this witness statement:

   A. Why Goldman Sachs wishes to join the Application

   B. How Goldman Sachs can assist the court

   C. The factual background on the ways in which Financial Institutions actually fund themselves

   D. The proper interpretation of "Default Rate" in the ISDA Master Agreement

   E. Correspondence with the parties

   F. Conclusion

A. WHY GOLDMAN SACHS WISHES TO JOIN THE APPLICATION

7. Goldman Sachs and its affiliate Goldman Sachs Lending Partners LLC are major creditors of LBIE. A large part of these claims arise under ISDA Master Agreements. Goldman Sachs has therefore followed closely the progress of the Application.

8. Goldman Sachs wishes to join the Application in order to make submissions on one issue only, namely the proper interpretation of the definition of "Default Rate" in the 1992 and 2002 ISDA Master Agreements. In particular, Goldman Sachs wishes to address the specific and limited question of whether the definition of Default Rate encompasses all sources of funding, including equity, rather than being restricted to the cost of borrowing.

9. This issue is broadly covered by Issues 11 and 13, as originally formulated, though Goldman Sachs' submissions may have certain consequences for Issue 12 (regarding the term of funding on which the Default Rate is to be calculated), Issue 14 (regarding the approach that must be taken in certifying a cost of funding) and Issue 27 (as regards the question of whether different rules should apply to Financial Institutions compared with other types of parties).

10. As I explain further at paragraphs 41 and 42 below, I am aware from very recent correspondence with the Joint Administrators' solicitors that the parties have agreed a reformulated version of Issues 11 and 12. The reformulated issues were provided to

my firm in draft on 5 May 2015, and have now been set out in the Order of Mr Justice David Richards dated 9 March 2015 and sealed on 7 May 2015, which my firm obtained from the LBIE administration website on 8 May 2015. While Goldman Sachs anticipates that the points it wishes to argue will fall within the language of Issues 11 and 12 as reformulated, to the extent that these arguments are said to fall outside the existing issues Goldman Sachs reserves the right to submit that the issues should be widened and/or otherwise amended to allow to these arguments to be advanced.

11. Goldman Sachs is concerned that the position of Financial Institutions may not be adequately addressed and/or protected by the current parties' approach to the issues in dispute. In particular, Goldman Sachs is concerned that Financial Institutions be entitled to recover their cost of funding the relevant amounts, including costs incurred through equity funding. Although I understand from correspondence with the Joint Administrators' solicitors that the parties are to file and serve supplemental position papers [**pages 18 to 20**], on the basis of the parties' positions as previously stated, Goldman Sachs' concerns include that:

    A. The manner in which Financial Institutions fund themselves is not necessarily the same as that which might apply to hedge funds (such as the existing Respondents) or to other corporate counterparties. In particular, Financial Institutions are compelled by regulation and/or the market to fund their assets with a portion of equity, and in some cases they may be compelled to respond to losses by raising additional equity, or may simply deem it prudent to do so.

    B. At least one of the existing Respondents ("**Wentworth**", the Fourth Respondent) has already sought to identify Financial Institutions as a class of relevant payee and impose upon them a different (and adverse) treatment for certification of Default Rate (Wentworth's position paper, paragraphs 71 to 72), taking the position that Financial Institutions should be limited to recovering their average cost of borrowing regardless of costs actually incurred in funding the relevant amount owed upon an ISDA default. While it appears from correspondence with the Joint Administrators' solicitors (see paragraphs 30 to 43 below) that this argument may now have been partially or entirely abandoned by Wentworth, the fact that it has been and could be

advanced illustrates the danger of leaving a major class of creditor unrepresented before the court on this Application..

B. HOW GOLDMAN SACHS CAN ASSIST THE COURT

12. Goldman Sachs considers that it can provide valuable assistance to the court in interpreting the definition of "Default Rate" and in considering the Issues regarding Default Rate the following reasons:

    A. If Goldman Sachs is permitted to intervene in the Application it will be able to ensure that the interests of Financial Institutions are directly represented and that arguments relevant to them are heard.

    B. In particular, an important question in interpreting the definition of "Default Rate" in the ISDA Master Agreement is whether and to what extent it encompasses the cost of equity used to fund the relevant amount. Goldman Sachs is well placed to put relevant factual evidence before the court on the importance of equity finance to Financial Institutions, which forms part of the factual matrix that must be considered in interpreting the definition of "Default Rate". Likewise, Goldman Sachs is well placed to assist the court in understanding the conditions applying to Financial Institutions in the 1990s and 2000s when the ISDA Master Agreements between LBIE and Financial Institutions were concluded and at the time when the LBIE default occurred.

    C. A decision on the proper interpretation of the definition of "Default Rate" is relevant not just to these proceedings, but to countless other ISDA Master Agreements concluded between parties around the world over many years. Financial Institutions, including Goldman Sachs, are among the principal counterparties to these agreements. Goldman Sachs's participation will ensure that the broader commercial implications of the court's decision are properly canvassed.

13. As detailed below (paragraphs 30 to 43), Goldman Sachs has raised the possibility of applying to be joined to the Application as a Respondent in correspondence with the Joint Administrators' solicitors (copied to the solicitors for the Senior Creditor Group, Wentworth and York Global Finance), who have confirmed that the Joint

Administrators are content for the application to be made **[pages 18 to 20]**. None of the other parties have objected, however Wentworth's solicitors have stated that they are unable to confirm Wentworth's position **[pages 23 to 24]**.

14. Furthermore, allowing Goldman Sachs to join the Application should have no effect on the existing trial timetable. The trial is due to commence on 9 November 2015 with a time estimate of 7 to 10 days. Goldman Sachs is willing and able to present its position, including any evidence that may be required, within the current timetable so that the trial date will be unaffected. Goldman Sachs is otherwise willing and able to follow the existing pre-trial timetable, on the basis that it will meet the same deadlines as are applicable to the Senior Creditor Group.

C. THE FACTUAL BACKGROUND ON THE WAYS IN WHICH FINANCIAL INSTITUTIONS ACTUALLY FUND THEMSELVES

15. The fact that Financial Institutions (and other parties) rely on funding from multiple sources is part of the factual matrix against which the ISDA Master Agreements must be construed. It is particularly relevant in the context of the LBIE default, since LBIE had many Financial Institution creditors, many of which were deleveraging at that time and raised equity to replenish capital that had been reduced by losses.

16. Financial Institutions fund themselves from a number of sources, including (without limitation):

    A. by borrowing new debt on the capital markets; and

    B. by issuing equity in exchange for capital investment.

17. In relation to the proper ratio of debt to equity capital, Financial Institutions are subject to capital adequacy requirements. In general these requirements require Financial Institutions to maintain a certain amount of capital, measured as a proportion of their overall asset base. These capital requirements are referred to, inter alia, as "capital ratios". These requirements have been imposed on banks pursuant to international agreements since at least 1988, when the Basel Committee on Banking Supervision published the first Basel Accord known as Basel I. In June 2006, the Basel Committee on Banking Supervision published a revised Accord known as Basel

II. Both Basel I and Basel II were implemented in the EU by EU Directives, and in the UK by regulatory rules. Capital adequacy requirements are also imposed in other jurisdictions including, at least, the United States.

18. The requirement to maintain adequate resources, including financial resources, is also set out in statute: as originally enacted, section 41 of the Financial Services and Markets Act 2000 ("**FSMA**") imposed threshold conditions for firms seeking authorisation to carry on regulated activities (such requirements are now imposed under section 55B FSMA). Authorised firms were, and are, required satisfy and to continue to satisfy the threshold conditions in order to retain their permission to carry on regulated activities. Paragraph 4, Schedule 6 FSMA set out as a threshold condition, "*The resources of the person concerned must, in the opinion of the Authority, be adequate in relation to the regulated activities that he seeks to carry on, or carries on*" (a similar requirement is now set out in Paragraph 2D(1), Schedule 6 FSMA). These rules, together with the detailed rules implementing Basel II, require that authorised firms maintain an absolute minimum amount of capital.

19. In addition, Financial Institutions are required to maintain a level of capital above the absolute minimum requirement, in order to provide a 'cushion' for the regulators, to maintain the confidence of the capital markets and of counterparties / customers with which they carry on business, and to satisfy the ratings agencies. Even where not required to do so, Financial Institutions may choose – depending on market and other factors – to raise equity capital and reduce leverage as a matter of prudence and sound business judgment.

20. Market conditions in 2008–9 and the specific circumstances surrounding the collapse of Lehman gave rise to circumstances where numerous Financial Institutions raised equity funding:

    A. It was widely recognised that the 2008 "credit crunch" placed significant strain on Financial Institutions which were under pressure from both regulators and the market to raise further capital. Several Financial Institutions came close to collapse and had to be rescued by competitors. Other Financial Institutions had to raise substantial amounts of capital from private and government sources.

B. The default of Lehman, in particular, resulted in substantial losses being sustained by many Financial Institutions, both in the scale of the amounts owed by Lehman entities and in the very limited recovery expected on the defaulted sum (8.375%, based on the Lehman Credit Default Swap auction conducted in October 2008 following Lehman's default).

21. The time period in and around Lehman's collapse therefore provides a clear example of a situation where Financial Institutions were required to fund losses by raising new equity capital from investors.

D. THE PROPER INTERPRETATION OF "DEFAULT RATE" IN THE ISDA MASTER AGREEMENT

22. The definition of Default Rate, at Clause 14 of both the 1992 and 2002 ISDA Master Agreements, reads as follows:

> *"**"Default Rate"** means a rate per annum equal to the cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount plus 1% per annum."*

23. Goldman Sachs' position as to the cost of funding issues and the proper interpretation of "Default Rate" will be addressed in its position paper if it is joined to the Application as a Respondent, and will also be a matter for submissions in due course.

24. In summary, however, Goldman Sachs's position is that, on its proper construction, the definition of Default Rate does not limit a relevant payee to the cost of any particular type of funding, and that it should be construed as permitting a relevant payee to certify a cost of funding that takes into account all of its sources of funding, including the cost of equity, subject to the obligation to provide such certification rationally and in good faith.

25. I am aware that Wentworth filed a supplemental position paper addressing the reformulated Issues 11 to 13 on 6 May 2015 [**pages 18 to 20**]. However, given that it was made available only on the evening of 7 May 2015, as this statement was being finalised, Goldman Sachs has not considered it in detail nor had an opportunity to take

advice on the position paper. I therefore make this statement without reference to, or consideration of, Wentworth's supplemental position paper.

26. Goldman Sachs reserves its position pending review of Wentworth's supplemental position paper.

E. CORRESPONDENCE WITH THE PARTIES

27. By way of summary, Goldman Sachs and my firm have corresponded with the parties' solicitors since 16 March 2015, shortly after the Case Management Conference on 9 March 2015 (the "**CMC**"). It has proved difficult to progress matters through correspondence and, despite a number of requests for materials that have passed between the parties and to be included in correspondence on reformulating the cost of funding issues, the Joint Administrators have refused Goldman Sachs' requests on the basis that it is not a party to the Application.

28. In relation the Goldman Sachs' application to join the Application as a Respondent:

    A. the Joint Administrators' solicitors have indicated that the Joint Administrators are content for Goldman Sachs to make an application to be joined and that it should do so if it wishes to advance arguments not advanced by the current parties [**pages 18 to 20**];

    B. the Senior Creditor Group's solicitors have acknowledged that Goldman Sachs "*has a material and legitimate interest in the issues concerned*" [**pages 13 to 14**] and have not indicated any objection to Goldman Sachs' joining the Application;

    C. Wentworth's solicitors have stated that they are unable to confirm Wentworth's position [**pages 23 to 24**]; and

    D. the Fifth Respondent, York Global Finance BDH LLC, has not taken any position on the cost of funding issues. Nonetheless the solicitors to the Fifth Respondent have been copied on the correspondence involving Goldman Sachs and have not indicated any objection to Goldman Sachs joining the Application.

29. Against that background, I detail below the correspondence between Goldman Sachs and my firm on the one hand and the existing parties to the Application on the other hand.

30. On 16 March 2015, Goldman Sachs wrote to the parties' solicitors noting that it was considering its position, including as to whether it might apply to be joined to the Application **[pages 1 to 2]**. In order to seek to save costs, streamline the process of Goldman Sachs considering whether to intervene, and for efficient case management reasons, the letter requested materials exchanged between the parties and their solicitors on the relevant issues, and also asked that my firm be copied on future correspondence. The letter also requested that the Joint Administrators post a summary on the LBIE website of any agreed positions between the existing parties on the cost of funding questions. Goldman Sachs also indicated its expectation that, if it were to be permitted to join the Application, it would have no impact on the trial date which was then understood to be 19 October 2015 following the case management conference on 9 March 2015.

31. On 31 March 2015, Linklaters LLP, solicitors for the Joint Administrators, wrote to my firm in response to Goldman Sachs' letter **[pages 3 to 4]**. The letter stated that the Joint Administrators were not willing to provide past correspondence on issues 11 and 12 and that the Joint Administrators did not consider it appropriate to copy my firm on future correspondence. The letter stated that the skeleton arguments for the CMC would be published on the LBIE website and that the reformulated cost of funding issues would be provided to my firm once agreed by the parties, albeit with no commitment that any amendments would be made to reflect any such comments. The letter also confirmed that information on agreed positions on the cost of funding issues would be published on the LBIE website.

32. My firm responded on 8 April 2015 **[pages 5 to 6]** to request a copy of Wentworth's further explanation of its position in relation to the alleged market usage of the term "Default Rate" among financial institutions and credit institutions, as well as copies of the skeleton arguments for the case management conference on 9 March 2015 (which had not been published on the LBIE website by the date of my firm's letter) and a copy of the Order following the case management conference.

33. On 9 April 2015, Linklaters LLP responded to my firm **[pages 7 to 8]**. The letter enclosed copies of the parties' skeleton arguments for the CMC. It also stated that Wentworth's solicitors, Kirkland & Ellis International LLP, had informed the parties that it "*no longer intends to pursue a case that the expression "cost...if it were to fund...the relevant amount" has any generally understood (i.e. market usage) meaning within any particular market*". The relevant correspondence from Wentworth's solicitors was not provided. The letter also stated that the reformulation of the cost of funding issues and the Order following the CMC remained subject to discussion between the parties.

34. My firm replied to Linklaters LLP on 10 April 2015 **[pages 9 to 10]**, noting that Wentworth's "market usage" position was unclear and requesting a copy of Wentworth's further explanation of its position. The letter also requested information on any agreed or anticipated deadlines up to the end of May 2015 in the proceedings.

35. Linklaters LLP responded on 13 April 2015 **[pages 11 to 12]** declining to provide the relevant correspondence, but providing some further information on Wentworth's position. The letter stated that Wentworth no longer intends to pursue the position set out in paragraph 71 of its position paper, that it no longer contends that there is any difference between Financial Institutions and Credit Institutions on the one hand and other entities on the other in relation to Issues 11 and 12, and that the position set out in paragraph 72 of Wentworth's position paper is of general application. The letter also stated that no procedural steps were anticipated before the end of May in relation to the relevant issues, with the exception that Wentworth may be required to file expert evidence on New York law in mid-May 2015. In fact, this does not appear to have been an accurate summary of the position, since a Pre-Trial Review appears to have taken place on 21 April 2015 at which the very issues in question were raised (see paragraph 39 below).

36. On 14 April 2015, Freshfields Bruckhaus Deringer LLP, solicitors to the Senior Creditor Group, wrote to Linklaters LLP **[pages 13 to 14]**. The letter recorded the position of the Senior Creditor Group that Goldman Sachs has a material and legitimate interest in the issues and that the Administrators should agree to the requests made by my firm and provide the information requested.

37. My firm then wrote to Linklaters LLP on 20 April 2015 **[pages 15 to 17]** noting that Wentworth's position remained unclear and repeating the previous requests for all relevant materials exchanged between the parties and to be copied on correspondence relating to the cost of funding issues. The letter also sought further information and confirmations, including as to the parties' positions on the definition of the term "Default Rate", any market usage or practice that may be alleged to be relevant to its interpretation and whether costs associated with both equity and debt funded may be included.

38. Also on 20 April 2015, it seems that the parties filed skeleton arguments for a Pre-Trial Review listed for 21 April 2015. The skeleton argument filed on behalf of the Joint Administrators includes five paragraphs relating to Tranche C issues, and noted that "*since the last CMC, Wentworth has abandoned its case in respect of the 'market usage' arguments. As a result, the parties are agreed that expert 'market usage' evidence of the type formerly envisaged is not required*".

39. On 21 April 2015, there was apparently a Pre-Trial Review at which Issues 11 and 12 and other case management issues relating to the matters in which Goldman Sachs has an interest were referred to a number of occasions. Mr Justice David Richards, at lines 16 to 18 of page 13 of the transcript, indicated that he was "*slightly concerned that here we are, well over a month later, and we do not have an order [from the 9 March 2015 CMC] finalised yet*". It appeared from the transcript that the 9 March 2015 CMC Order had not been finalised because the existing parties had not agreed a revised formulation of Issues 11 and 12, although Mr Dicker QC at lines 18 to 22 of page 22 of the transcript, indicated that they were "*very close to agreeing*" a revised formulation.

40. My firm was not given any notice of the Pre-Trial Review, or that relevant issues would be raised at it. Copies of the transcript and skeleton arguments were obtained from the LBIE administration website on 28 April 2015 and 29 April 2015 respectively. My firm also obtained a copy of the Order of Mr Justice David Richards dated 22 April 2015 from the LBIE administration website on 28 April 2015.

41. On 5 May 2015, Linklaters LLP responded to my firm's letter of 20 April 2015 **[pages 18 to 20]** stating that materials would not be provided and my firm would not

be copied on correspondence unless and until Goldman Sachs was joined to the Proceedings, and declining to respond to the questions and requests for confirmations set out in my firm's letter of 20 April 2015. It also enclosed a draft Order following the CMC, on which Goldman Sachs comments were invited in time for the Order to be lodged for sealing at 11am the next day, and noted that Deutsche Bank had been provided with the same information and also invited to comment on the draft Order. The letter stated that the parties intended to file and serve supplemental position papers addressing the reformulated Issues 11 to 13, and that it had been agreed that Wentworth would do so by 6 May 2015 with the Senior Creditor Group and Joint Administrators to do so by a date to be agreed. The letter also recorded that the Joint Administrators are "*content for [Goldman Sachs] to make an application to be joined as a Respondent to the Application, if [Goldman Sachs] are of the opinion that its arguments are not being fully put by the parties in response to the reformulated issues*".

42. My firm replied on the same day, 5 May 2015 [**pages 21 to 22**], noting that it was impractical for Goldman Sachs to provide comments on the draft CMC Order in the extremely short timeframe proposed by the Joint Administrators and reserving Goldman Sachs' right to comment at a later date. The letter also requested that Wentworth's solicitors confirm on behalf of Wentworth that they had no objection to Goldman Sachs joining the Application in relation to the cost of funding issues. The letter requested such confirmation from Kirkland & Ellis International LLP on behalf of Wentworth during the course of 6 May 2015.

43. On 6 May 2015, Kirkland & Ellis International LLP responded [**pages 23 to 24**] stating that they were unable to confirm Wentworth's position on Goldman Sachs joining the Application in relation to the cost of funding issues. The letter stated that this was because Goldman Sachs had not set out the arguments it proposed to make and why they differ from the arguments raised by the Senior Creditor Group.

44. To date, my firm has not received the correspondence and materials that have been exchanged between the parties, nor has Goldman Sachs been allowed to participate in the correspondence between the parties about the reformulated Issues 11 to 13. (Nor has the summary of agreed positions on the other Part C issues yet been published on the LBIE website.) The Joint Administrators' position is that Goldman Sachs will not

be copied on such correspondence in future "*unless and until [Goldman Sachs] is joined to the proceedings*" **[pages 18 to 20]**. If Goldman Sachs is permitted to join the proceedings, I therefore respectfully request that the court makes such orders as may be necessary to ensure that Goldman Sachs has equal access to the relevant information and to ensure that Goldman Sachs is able to set out its position in a position paper to be filed at the same time as any supplemental position paper to be filed by the Senior Creditor Group or the Joint Administrators in relation to the reformulated Issues 11 to 13.

F. CONCLUSION

45. In light of the matters described above, I respectfully submit that:

    A. it is desirable and appropriate to add Goldman Sachs as a respondent to the Application so that the court can resolve all the matters in dispute in the proceedings; and

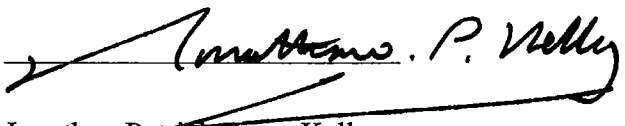
    B. there is an issue, namely the proper interpretation of the term "Default Rate", involving Goldman Sachs and the existing parties which is connected to the matters in dispute in the Application, and it is desirable and appropriate to add Goldman Sachs as a respondent to the Application so that the court can resolve that issue with the benefit of input from all interested parties.

46. Moreover, allowing Goldman Sachs to join the Application would have no effect on the existing trial date, commencing 9 November 2015 with a time estimate of 7 to 10 days. Goldman Sachs is willing and able to present its position, including any evidence that may be required, within the current timetable so that the trial date will be unaffected.

47. I respectfully request that the court makes an order in the terms sought.

STATEMENT OF TRUTH

I believe that the facts stated in this witness statement are true.

Signed: 

Jonathan Patrick Knox Kelly

Date: 8 May 2015

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